UBAM - MEDIUM TERM US CORPORATE BOND

Quarterly Comment

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Market Comment

- Central banks were in focus in October as ongoing fears around inflation led investors to pull forward their rate hike expectations substantially. This was initially driven by the Bank of England after Governor Bailey signalled that they would have to act in the coming meetings, which resulted in investors anticipating a rate hike as soon as the November meeting. This put pressure on short-end rates across developed markets, with curves seeing significant flattening moves as a result.
- Other G10 central banks added to the hawkish rhetoric as the Bank of Canada brought forward its rate hike guidance from the second half of 2022 to the middle of the year, whilst they also surprisingly decided to end asset purchases. Meanwhile the Reserve Bank of Australia chose not to defend its yield curve target despite the move higher in rates observed, signalling an effective end to its Yield Curve Control policy.
- In contrast, President Lagarde stuck to her dovish tone at the ECB meeting, noting that market pricing for a 2022 rate lift-off, or anytime soon thereafter, is inconsistent with the ECB’s inflation forecast and forward guidance. This did not prevent German 2 year yields rising by 10 bps in October however, whilst the US 2 year yield rose by 22 bps, with the market now pricing a Fed rate hike as soon as tapering is expected to end in mid-2022.
- The substantial curve moves saw the 5s30s US rates curve flattening by 33 bps in October and the equivalent German curve by 31 bps, in what was a twist flattening move with short-end rates rising and long-end rates declining. Despite the volatility observed in rates markets, credit spreads were relatively resilient with US Investment Grade spreads unchanged at 66 bps in October whilst European spreads were 3 bps wider at 87 bps. Support for credit likely came from corporate earnings for Q3 which continued to impress across sectors, whilst data released out of the US confirmed an improvement following the Delta induced weakness over the summer, with both ISM manufacturing and service surveys surprising on the upside.
- Risk markets suffered towards the end of November following the emergence in South Africa of a new Covid variant known as Omicron, which the WHO described as a variant of concern. Given the initial lack of information on the severity of the strain, governments chose to act with caution, with many countries implementing tighter travel restrictions and longer quarantine periods whilst awaiting further details. Markets also reacted with caution, with the S&P 500 ending November with a loss, whilst credit spreads suffered into month-end. For example, European investment grade spreads finished November 23 bps wider and the US equivalent was 15 bps wider.

- Moves herein were likely exacerbated by the fact that the Omicron news was released during the US Thanksgiving holiday, at a time when liquidity in markets is reduced and which likely added to market volatility. These developments also led to a bid for safe haven assets such as US Treasuries with US 10 year yields declining by 11 bps in November and German 10 year Bund yields 24 bps lower.
- The underperformance of US Treasuries versus German Bunds was most likely down to the hawkish shift in rhetoric from Fed members during the month, who opened the door to accelerating the tapering pace of asset purchases as inflation concerns rose. This was especially the case following another stronger than expected inflation print, with headline inflation printing at 6.2% YoY which is the strongest reading since 1990. This hawkish shift from the Fed was emphasised by Chair Powell at the end of the month, as he said that it was time to “retire” the word transitory with regards to inflation and that it was appropriate to consider wrapping up tapering a few months sooner than previous guidance.
- Risk markets ended 2021 on a positive note as initial concerns around the new Covid variant Omicron were tempered following preliminary data out of South Africa, which suggested that the symptoms of this strain were not as severe as first feared. Investors took comfort from the possibility of a lower hospitalisation and fatality rate from this variant, as it reduced the likelihood of governments enforcing strict lockdown measures once again.
- As a result, the S&P 500 reached another all-time high towards the end of the year, whilst credit spreads partially recovered the widening in spreads observed in November following the initial Omicron scare. Amid this backdrop, US Investment Grade credit spreads ended the month 7 bps tighter whilst European spreads were 12 bps tighter.
- The emergence of Omicron was also not enough to prevent central banks from moving ahead with their plans to reduce the high levels of monetary accommodation that have been provided since the onset of the pandemic, as they instead chose to focus their attention on rising inflation concerns. For example the Fed doubled its tapering pace and revealed its latest dot plot projection which showed a median of 3 hikes for 2022, whilst the ECB confirmed that PEPP will end in March and also guided towards a lower than expected asset purchase program size for 2022.
- As a result, interest rate markets saw higher yields in December, with US 10 year yields rising by 7 bps whilst German 10 year yields moved 17 bps higher. Data released during the month also supported such central bank action as labour markets continued to tighten in the US with the unemployment rate declining by 0.4% to 4.2%, whilst the Fed’s preferred measure of inflation, core PCE, surprised to the upside once again and printed at 4.7% YoY, which is its strongest reading since the 1980’s.

Performance Review

- UBAM - Medium Term US Corporate Bond delivered -0.65% QTD net of fees (I Share class). In relative terms the strategy delivered +13 bps gross of fees vs. its benchmark: the ICE BofA US 1-10 years US Corporate Index.
- The excess returns sequentially over the quarter were: +7 bps in October, -8 bps in November and +14 bps in December.
- QTD, financials contributed -4 bps, non-financials -3 bps, hedging & overlay +21 bps and other items -1 bp.
- YTD, the fund returned -1.58% net of fees (I share class). In relative terms the strategy delivered -8 bps gross of fees vs. its benchmark: the ICE BofA US 1-10 years US Corporate Index.

Portfolio Activity

- At the end of the quarter, the yield of the portfolio was 2.2% vs 1.9% for the benchmark.
- The interest rate exposure was 4.0 years vs. 4.4 years for the index
- Main positions:
  - Overall credit exposure: overweight vs benchmark, overweight financials and corporates
  - Financials exposure: overweight banks senior, small underweight banks Tier II, underweight insurance
  - Corporates exposure: overweight TMT, autos and hybrids, neutral consumer, underweight industrials and utilities
  - Country exposure: underweight Latam, overweight US, UK, EU Core & periphery countries and China
  - Synthetics exposure: Long US CDS IG index

- In October, we maintained our overweight credit risk stance during the month with the relative risk-adjusted spread duration of the fund stable at +0.9 year. That said, we switched some non-financial senior bonds and CDX IG index exposure into energy hybrids in a context of strong oil & gas demand and pricing. On the rates side, we took profit on our short duration position on the 2-year part of the US curve leaving us neutral versus benchmark.
- In November, we moved to a short rates position at the end of the month on the back of Fed Chair Powell's testimony in which he said that the Fed can consider wrapping up its tapering plans a few months sooner, whilst he continued to note the risks of more persistent inflation despite concerns related to the Omicron variant.
- In December, we increased our overweight credit risk stance during the month with the relative risk-adjusted spread duration of the fund rising by 0.2 year to +1.0 year primarily through EM issuers amid easing concerns around the impact of the Omicron variant on economies. On the rates side, we moved to a -0.4 year short duration position on the 30 year part of the German yield curve.

All performance figures are given net of fees. Past performance is not a guide to current or future returns. See full disclaimer at the end of the document.

Outlook

- At the end of 2021, central banks took further steps towards removing the extreme levels of policy support that had been in place since the onset of the pandemic with the Fed doubling its tapering pace and the BoE surprisingly hiking interest rates. Despite Covid cases re-accelerating amid the Omicron wave, central banks chose to instead focus their attention on rising inflation concerns. This suggests that monetary policy is at an inflection point as we head into 2022, with the trajectory of inflation from here set to be a key determinant on whether the market is adequately pricing the tightening to come. Following the impressive vaccine and booster programs that have been implemented globally over the past year, a key question will also be whether the pandemic is at a turning point in 2022, where governments choose not to enforce strict lockdown measures with each new wave of cases. If this were to be the case as we are already seeing with the Omicron wave, then it should allow for supply side constraints, which have added to inflation fears and weighed on production in 2021, to fade. This would also allow for the growth recovery to continue and the service sector to finally normalise.
- The Fed at its December meeting continued with its hawkish shift on both the balance sheet and rate guidance, which Chair Powell had already warned of in November when he said that they would “retire” the word transitory when describing inflation. At the meeting itself, the Fed doubled the pace of its asset purchase tapering plans, whilst also guiding towards three rate hikes in 2022 based on their updated dot plot projections. The minutes from this meeting went a step further, where participants noted that it could be appropriate to begin to reduce the size of the balance sheet relatively soon after beginning to raise rates. More persistent inflationary pressures than the Fed had initially expected, as well as the strong recovery of the labour market likely drove this adjustment in forward guidance.
- For example Powell highlighted several labour market indicators such as the employment cost index and the quits rate which are at historical highs, where they now forecast the unemployment rate to hit 3.5% this year, which is 0.3% lower than their September prediction. On inflation, core PCE is now expected to end 2022 at 2.7% compared to 2.3% previously, whilst the 0.7% upward revision to 2021 core PCE highlights how the Fed was caught off guard by inflation strength into year-end. On the growth front, although we anticipate moderating growth in 2022 given less supportive fiscal policy following the emergency funding that was provided during the height of the pandemic, growth in the US should still remain above trend. This will likely be driven by the service sector recovery broadening as lockdown fears dissipate, whilst reduced supply side constraints through the year should allow inventories to be rebuilt.
- The ECB also reduced its policy support via the balance sheet in December as they not only confirmed the end of PEPP in March, but also provided details of the temporary increase in purchases through the APP during Q2 and Q3, although these figured underwhelmed expectations. This may be reflecting the ECB’s belief that progress is finally being made towards its inflation goal, as highlighted by the updated staff inflation forecast which sees core inflation averaging 1.9% for 2022 from 1.4% previously and

headline inflation at 3.2% compared to 1.7% in the previous forecast. Comments from President Lagarde also signalled a heightened vigilance around inflation, although she did rule out the possibility of hiking rates this year.

- Such developments described have confirmed our prior view that we have passed the peak in central bank stimulus and as such, we still see room for rates to rise. This is especially the case at a time when hawkish central bank actions are coming from several key DM economies away from just the Fed and ECB. Although we have seen yields move higher, the market continues to price the Fed less aggressively than its own dot plot projections. Specifically, market pricing for the Fed shows a total of 6.5 hikes out to 2024 at the time of writing, which compares to the Fed's median dot which shows 8 hikes, providing room for this gap to be narrowed. We anticipate for this move higher in rates to be an orderly one given that our base case remains for global inflation pressures to ease as 2022 progresses. We are already seeing signs of supply side constraints beginning to improve, as observed with shipping costs starting to normalise and chip production return, whilst commodity price stabilisation should also allow headline inflation to moderate.
- We continue to see this macro environment as positive for credit, as we do not anticipate an aggressive tightening in financial conditions from the hawkish central bank actions described. Although we do expect real rates to rise, they are rising from historically depressed levels and so should not be disruptive for risk assets. In addition, with central banks attempting to lift rates for the first time in many years, they are incentivised to do so in a smooth manner to allow them to lift rates high enough to provide room to cut rates again in a future downturn. We also see this hawkish shift as being one driven not only by inflation fears, but also as a consequence of the more robust global growth backdrop which has been accompanied by tightening labour markets. We anticipate for this growth picture to remain intact despite the pandemic continuing to cloud the outlook. Whilst new variants cannot be ruled out as we have observed with Omicron, this latest wave has also shown us that vaccines and boosters have done their job in decoupling case growth and fatalities. This reduces the likelihood of governments reintroducing strict lockdown measures and should allow economies to continue to normalize and for the service sector to drive the next leg of the recovery.
- We also see this backdrop as positive for credit from the micro perspective, given impressive and improving credit fundamentals following strong earnings growth in 2021 with prudent balance sheet management. For example net leverage for US Investment Grade names has fully reversed the increase observed during the pandemic, whilst a US HY default rate of under 1% for 2021 highlights how this segment of the market benefitted from the reopening of economies on the back of the vaccine rollout. Although there are plenty of concerns around inflation, our own analysis indicates that some inflation, if not too high, is actually good for corporates, where the inflation losers account for only 17% of the European IG credit market.

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